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C O N F I D E N T I A L SECTION 01 OF 02 BEIJING 003254

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STATE FOR EAP/CM, EAP/TC, EAP/EP, EEB/TPP/BTA
STATE PASS USTR FOR STRATFORD AND ALTBACH
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REGULATIONS STYMIE GROWTH

REF: (A) BEIJING 002952 (B) SHANGHAI 000410 (C)
SHANGHAI 000191

Classified By: Econ Minister Counselor William Weinstein. Reasons: 1.5 (b) and (d).

¶1. (C) SUMMARY: According to a host of industry experts, foreign PE firms looking to invest in China have two major concerns: 1) how to convert foreign currency into renminbi (RMB) in order to invest in Chinese firms; 2) how to exit from their investments to realize profits either in RMB or in foreign currency. The firms had various approaches to work around the various regulations that made currency conversion difficult, but were mostly in agreement that the current situation impeded foreign PE business and gave an unfair advantage to domestic PE. This is the second in a series of cables regarding China's nascent domestic Private Equity (PE) industry, the opportunities and challenges facing foreign PE firms in China, and Beijing's actions to shape the regulatory landscape. EconOffs in October and November met with a series of industry experts from both U.S. and Chinese private equity firms to gauge their sense of foreign PE firms' place within China's market and the country's current regulatory landscape. They agreed that Beijing wanted to foster the domestic private equity industry by using foreign firms' expertise while simultaneously protecting Chinese firms from foreign competition. END SUMMARY.

PUTTING MONEY IN IS TOUGH...

¶2. (SBU) Foreign PE firms looking to invest in Chinese small and medium-sized companies as of late 2009 faced a number of problems exchanging currency, according to a host of industry experts. First, converting foreign currency into RMB required a difficult and opaque approval process. For instance, one investor with a small U.S. PE firm told us he could not compete with domestic funds, which could transfer capital to a Chinese company "immediately." The U.S. firm, on the other hand, was required to comply with Circular 142, which requires foreign-funded firms to get approval from the State Administration for Foreign Exchange (SAFE) for each specific deal before converting any funds into RMB. This regulation, although ostensibly designed to curb "hot money inflows," in effect acted to protect China's domestic industry from foreign competition.

¶3. (SBU) Chinese PE firm Hony Capital CEO John Zhao, on the other hand, told Econoffs on November 4 that Circular 142 has not affected his business at all, despite the fact that he

gets much of his funding from overseas. He said he simply applies for, and receives, regulatory approval or waivers for his currency conversions. (Comment: U.S. firms unanimously put currency conversion on the top of their complaint list, suggesting that the ease with which the Chinese firm Hony Capital exchanged currency was unusual. The different experiences may indicate favoritism toward Chinese firms on the part of regulators. End Comment.)

¶4. (SBU) Carlyle's Hong Kong-based Director Eric Zhang on November 10 told EconOffs he was concerned that the China Partnership Law, which says that only domestic entities can sponsor a partnership, would result in higher taxes for Carlyle. Because foreign firms required a wholly foreign-owned enterprise (WFOE) to be the General Partner sponsor, they would be subject to the relatively high tax regime imposed by WFOE regulations. Carlyle was also concerned that the difficulty in converting foreign currency into RMB would pose problems in making the standard one to three percent of the fund available to the general partner as a salary.

¶5. (SBU) Second, large foreign PE firms such as Carlyle, KKR, and Blackstone increasingly sought to raise RMB funds within China, which would allow them to access China's rising stocks of wealth and circumvent Circular 142 restrictions. Beijing historically has prevented foreign firms from raising RMB funds, but the August 2009 draft foreign-invested partnership (FIP) regulations could allow foreign investors to both raise RMB funds and contribute RMB to Chinese funds, according to industry experts. The new regulation, however, would still

require foreign firms to obtain MOFCOM's approval for each deal, and probably would not loosen sectorial investment restrictions listed in the Foreign Investment Catalogue. Moreover, Carlyle's Eric Zhang told EconOffs that allowing foreign funds to contribute to a master RMB fund as a limited partner was "a bit difficult," given the upward pressure on the RMB in the last few months.

...AND SO IS GETTING IT OUT

¶6. (SBU) In the same vein, foreign firms increasingly sought to exit from their investments by listing their companies in Chinese securities markets. Some firms were attracted to the relative regulatory ease of remaining in China for the last phase of the business cycle, while others believed that China's rising wealth would lead to better profit margins on the Mainland than offshore, according to a contact working at a small U.S. PE firm. This strategy, however, only delayed the inevitable hassle of converting the RMB sale profits into USD, which required SAFE's approval.

¶7. (SBU) A possible liberalization might come from the China Securities Regulatory Commission (CSRC), which in mid-October took comments on its draft Measures for the Administration of Securities Registration and Clearing for comments. The new regulations might allow PE firms to open securities accounts, according to the U.S. Chamber of Commerce. This could ease foreign firms' sale of stock in Chinese markets, but CSRC has not yet indicated what any new draft might look like, and the historical lack of transparency with which agencies have applied regulations give us an unclear picture of how the new rules might be interpreted.

OTHER REGULATIONS MUDDY THE WATERS

¶8. (SBU) The National Development and Reform Commission (NDRC)'s draft PE Fund Regulations, which were submitted to the State Council in August 2009, were likely to apply to both foreign and domestic funds and could require all funds formed within China--including foreign RMB funds--to file with NDRC. Carlyle's Zhang said that one of his company's biggest concerns was that the new regulations would give NDRC increased regulatory power over foreign firms. However, NDRC

had not yet published its draft and would not meet with EconOffs to discuss its proposal.

PE COPING MECHANISMS: GETTING ALONG BY HOOK OR BY CROOK

¶9. (C) PE funds have developed a number of methods to decrease the time and money spent on seeking regulatory approval to convert currency and invest in Chinese firms. For instance, Hony Capital's John Zhao noted that his company has conducted all of its business legally but that it often had to receive exceptions to the rules on the books in order to put together deals. Zhao appeared confident that his firm would continue to prosper within the changing regulatory environment because PRC regulators realize that the domestic industry needs people who understand both the PE industry and domestic Chinese businesses.

¶10. (C) Similarly, foreign PE firm Vice President Wang Wenyong on November 27 told EconOffs that circumventing the rules was easy. His PE firm would loan U.S. dollars to a U.S. bank branch located outside China. In turn the bank's mainland branch would loan his firm the RMB equivalent. When applying to SAFE for approval to invest in a Chinese firm, SAFE wanted to know where the firm had gotten its RMB funds. The PE firm could then accurately tell SAFE it had received its RMB from a bank loan rather than a currency exchange.

¶11. (C) Regarding anti-monopoly regulations, Carlyle's Zhang said that his firm only files anti-monopoly paperwork when specifically told to by Chinese regulators, despite being encouraged to file for every investment. "It just causes too many headaches and we'd never get anything approved," according to Zhang.
HUNTSMAN